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District Counsel, Laguna Niguel  
Attn: Sherri Spradley

Assistant Chief Counsel (Income Tax & Accounting) CC:IT&A  
National Office

Request for Technical Assistance  
Sections 3406 and 6672

We are responding to your memorandum of July 25, 1991, requesting technical advice [assistance]. You ask whether penalties may be applied against municipalities that fail to backup withhold on payments when notified by the Service that Forms 1099 MISC were issued with incorrect taxpayer identification numbers (TINS).

CONCLUSION

We conclude that the tax may be assessed and collected from a municipality under section 3406 of the Internal Revenue Code. Appropriate penalties may also be assessed. However, section 6672 is not an appropriate vehicle in this instance.

DISCUSSION

Under section 3406(h)(10) of the Code, with certain exceptions, payments that are subject to withholding under section 3406 are treated as if they were wages paid by an employer to an employee (and amounts deducted and withheld under this section are treated as if deducted and withheld under section 3402).

Under section 6672(a) of the Code, any person who is required to collect, truthfully account for, and pay over any tax imposed and willfully fails to do so, or willfully attempts in any manner to evade or defeat any tax or payment of tax shall be liable for a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Under Q&A2 35a.9999-3 of the Temporary Employment Tax Regulations, a payor is subject to the same penalties for failing to impose backup withholding under section 3406 of the Code as an employer making a payment of wages. In addition to liability for the tax, a payor who fails to withhold when required may be subject to civil penalties under sections 6651, 6656, and 6672.

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Rev. Rul. 88-53, 1988-1 C.B. 384, holds that rental assistance payments made by public housing agencies to non-corporate owners of housing projects are subject to information reporting under section 6041(a) and (d) of the Code and must file Forms 1099-MISC. Public housing agencies are also required to backup withhold under section 3406 on payments made to payees who are subject to backup withholding. Under the reasoning of the revenue ruling, a public housing agency is an organization of the type described in section 1.6041-1(g) of the regulations (the United States or a state, or political subdivision thereof), and is, therefore, a "person[s] engaged in a trade or business" as defined in section 1.6041-1(b).

Using the same reasoning as set forth in Rev. Rul. 88-53, a city or municipality is a political subdivision of a state, as defined under section 1.6041-1(g) of the regulations. As such, it is required to file information returns (in this case, Forms 1099-MISC) to report payments made under section 6041 of the Code. As a payor required to file information returns, the city or municipality is also required to backup withhold under the provisions of section 3406 on payments made to payees who are subject to backup withholding.

Policy Statement P-2-4, approved November 6, 1981, states that no penalties will be asserted against federal agencies. This was based upon a ruling from the Comptroller General that appropriated funds may not be used to pay penalties and interest. There was no mention of state and local governments in the policy statement, and section 5173.3 of the Internal Revenue Manual states that penalties have been assessed and collected from state and local governments since 1975. According to the Manual, a diligent effort should be made to secure voluntary compliance before taking enforcement action.

Although section 6672 of the Code may be read as a penalty provision, historically the Service has interpreted and used this section as a collection device only. The amount of the "penalty" is measured by the tax required to be collected. The purpose and application of section 6672 is stated in Policy Statement P-5-60. If a corporation willfully fails to collect taxes, the "100-percent penalty" may be asserted against the responsible officers and employees of the corporation provided the taxes have not been collected from the actual taxpayers or from the corporation itself.

Under section 3406(h)(10) of the Code and Q & A 2 of 35a.9999-3 of the temporary regulations, payments that are subject to backup withholding are treated as if they were wages

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paid by an employer to an employee, and a payor who fails to impose backup withholding is subject to the same treatment as an employer making a payment of wages. Thus, backup withholding taxes owed by the city of [REDACTED] are subject to assessment and collection in the same manner as employment taxes. However, the city of [REDACTED] would not be subject to section 6672. If the taxes cannot be collected from the city, section 6672 may be asserted against the responsible employees or city officials. We suggest that you contact the office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) for further questions on assessment and collection of the employment taxes.

Should you have any further questions on this subject, Mary Jane Kossar of my staff is familiar with this issue and can be reached on FTS 566-3453.

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(Signed) Norlyn D. Miller, Jr.

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